THE PROBABLE EFFECTS OF THE NEW CURRENCY ACT ON BANK INVESTMENTS

Any notable change in the banking system of a modern industrial country may be expected to affect the accustomed policies of four distinct elements of the community: the national treasury, the users of credit, the owners of the banks, and the public at large. This is as certain to occur in outcome of the Federal Reserve act of December 23, 1913, as in train of the two other great events in our banking history—the veto of the charter renewal of the Second Bank of the United States in 1832 and the passage of the National Bank act in 1863. The purpose of the present paper is to consider the effect of the act upon the banks themselves, so far, at least, as concerns their actual investments and their future investing policy.

A bank's investment might be defined as that part of its resources embodied in income-yielding securities, acquired or retained outside of the course of its normal functions of loan and discount. This definition serves to exclude, as non-income yielding, the banking plant and equipment, and, as only temporarily retained, the ordinary contents of the bank's portfolio—bills receivable, promissory notes, and commercial paper generally. So delimited, the assets of the national banks are reduced to two considerable items: (1) United States bonds deposited to secure note circulation, public deposits, or "on hand," and (2) securities other than United States bonds acquired for investment purposes. On January 13, 1914, the 7,493 national banks owned $792,056,800 United States bonds. On the same date their net holdings of securities other than United States bonds were $1,041,698,974. Combined, the two items exceeded the total capital and surplus of the banks.

The ownership of United States bonds by the banks has been a legal requirement since the passage of the National Bank act. Under the provision of law that every bank shall deposit prescribed quotas of bonds before beginning business, the ownership of some part of their aggregate holdings is mandatory. The preparatory requirements of the Aldrich-Vreeland act and the time restrictions

upon withdrawal of note circulation may be taken to explain the acquisition and retention of an additional amount. The policy of the Treasury in depositing public funds with the banks in times of monetary stringency upon the security of United States bonds is a further reason for such purchase. There remain to be accounted for a very large volume of United States bonds, the ownership of which by the national banks is to be explained by less specific, but generally related, considerations. The courtesy of Deputy Comptroller T. P. Kane has made it possible to supplement the data contained in the Comptroller of the Currency's report by exact information as to one phase, at least, of this problem. On October 21, 1913, the 7,509 national banks of the United States had United States bonds on deposit with the Treasurer of the United States to secure note circulation to the amount of $737,480,840. Of this aggregate, the deposits made in accordance with the provision requiring minimum bond deposits prior to beginning business were only $149,604,345, leaving what has been described as "excess" bond deposits to the amount of $587,876,495 to secure corresponding note circulation. To this must be added the further holdings ($50,610,110) deposited as security for public deposits and also an amount ($6,199,710) "on hand."[1]

The actual occasion and course of such "excess" holdings invite much more careful and detailed analysis than has been accorded thereto. In general it may be ventured that the disposition of the banks to take out circulation in excess of the amount of mandatory bond deposits has been induced by considerations of banking profit; but that even after any considerable profit has ceased to accrue therefrom, the maintenance of note circulation, involving of course

[1] The number of banks, capital, United States bonds deposited, amount required, and excess deposited, by geographical divisions, are as follows (October 21, 1913):

Division	Number	Capital	Bonds Deposited	Bonds Required	Excess Deposited
New England	450	$102,086,700	$ 63,814,100	$ 14,040,875	$ 49,773,225
Eastern	1,660	337,256,401	212,052,060	36,996,225	175,055,835
Southern	1,520	174,049,850	140,893,420	32,732,007	108,161,413
Middle	2,068	283,482,700	197,323,700	38,547,175	158,776,525
Western	1,285	72,577,500	55,992,130	16,344,375	39,647,755
Pacific	521	89,320,105	67,089,180	10,861,275	56,227,905
Hawaii	5	629,652	316,250	82,413	233,837
Total	7,509	$1,059,402,908	$737,480,840	$149,604,345	$587,876,495

the purchase and deposit of bonds, has come to be regarded as proper procedure for a normal conservative bank desirous of conducting its affairs in harmony with the spirit and intent of the National Bank act and its traditional administration.

Under the Federal Reserve act neither of the two purposes which have induced the banks to acquire and hold United States bonds—note circulation and public deposits—is finally retained. The provision of law requiring bond deposit as a condition precedent to the issue of a charter to a member bank is repealed, and note-issuing power is conferred upon, and will ultimately be exclusively exercised by, the district banks. Although the right of the Secretary of the Treasury to use member banks as depositaries is specifically preserved, Treasury funds are likely under ordinary circumstances to be deposited with district banks. The ultimate operation of the system thus seems to contemplate no other use for United States bonds by member banks than as ordinary income-yielding investment assets.

Bearing in mind the conditions and terms under which a large part of the bonds were acquired, such withdrawal of use threatened heavy loss to the banks. Moreover, from the Treasury's standpoint, the unfavorable effect upon market price of rapid or urgent liquidation of such securities was undesirable. These considerations induced the insertion in the new measure of elaborate provisions looking to the gradual conversion and redemption of the banks' holdings of United States bonds. Two years after the passage of the act, and at any time during a period of twenty years succeeding, that is to say from December 23, 1915, to December 23, 1935, any member bank may signify its intention to retire the whole or part of its outstanding circulation and to sell the corresponding deposited bonds. The bonds so released are to be acquired by the federal reserve banks as the basis of a corresponding issue of circulating notes. There are, however, important limitations upon this conversion privilege. Purchase of the bonds by the reserve banks is not obligatory, but subject to the discretion of the Federal Reserve Board. Not more than $25,000,000 bonds in the aggregate may be purchased in any one year. It is not clear, in the event of applications for retirement exceeding $25,000,000, how purchase

will be made, whether according to priority of application or to proportionate allotment, or by discretionary selection. Finally, not even the entire $25,000,000 is available, since included therein are such bonds possessing circulating privilege as the reserve banks may acquire independently and utilize by deposit for taking out "circulating notes." Such bond-secured circulating notes of the federal reserve banks are to be distinguished, of course, from the federal reserve notes, based upon collateral security.

The new measure thus contemplates the ultimate taking-over by the reserve banks at par and interest of a large part, possibly all, of the United States bonds now held by the member banks. To prevent contraction or to avoid change, this taking over is spread over a long term of years, with an expiry on the banks' option discouraging possible reluctance to withdraw circulation. In the interim the market price of such bonds will be maintained by the right of the district banks to buy in the open market or elsewhere either as a basis for circulation or for resale. On the whole, the provisions of the measure seem designed not so much to relieve the banks of their holdings as to maintain the price of the bonds. This is sound financial policy and a course probably not unacceptable to the banks.

More important both in absolute amount and in problematic future are the banks' holdings of securities other than United States bonds.[1] On January 13, 1914, the net volume of such securities was $1,041,698,974—the largest absolute amount and the third largest proportion relative to total banking assets held at a corresponding season in the history of the national banking system. Approximately the same aggregate ($1,094,185,585)[2] was distributed on June 4, 1913, the latest available date, as follows: railroad bonds $345,204,195; industrial ("all other") bonds, $220,120,541; public utility bonds, $197,459,668; state, county, and municipal bonds, $175,345,382; various other securities, $156,055,799.

Authority to make investments in bonds, although not expressly

[1] The growth of such holdings is analyzed by the present writer in a paper on "The Security Holdings of National Banks" in the *American Economic Review*, December, 1913, from which the paragraphs that follow have been extracted.

[2] No deduction is made of "bonds borrowed" ($43,215,465).

conferred, has been held to be included in the powers of a national bank to discount and negotiate promissory notes, bills of exchange, and other evidences of debt, and this administrative construction has been confirmed by judicial decision that national banks are authorized to purchase corporate and municipal bonds as such evidences of debt. Whatever doubt may have remained, in the absence of adjudication by the United States Supreme Court, was *de facto* dispelled in 1908 by the provisions of the Aldrich-Vreeland act looking to the possible acceptance of bonds other than United States bonds as security for additional note circulation.[1]

The motives leading to such investments have been in some cases specific and local—as the purchase of the bonds of a particular state or city for tax-exemption purposes, or to serve as the legal or practical requisite for securing public or semi-public deposits. So, too, the profitable banking account of a private corporation may sometimes be more certainly retained by participation in its financing. But such purchases, as well as the bonds acquired by the taking-over of hypothecated securities, explain only a fractional part of the banks' aggregate holdings.

As familiar banking practice, the purchase and ownership of such securities by the national banks has been commonly explained upon the theory of a "secondary reserve." Sound banking policy, it is held, dictates that cash reserves should be supplemented by income-producing investments of indubitable safety and easy marketability—available for quick, favorable conversion into cash when monetary drain threatens exhaustion of the primary reserve. Bonds—state, county, municipal, railroad, public utility, and industrial—have been the only forms of investment legally available, or at least available in sufficient amount, for this purpose. Such inference is confirmed by the fact that the country banks have throughout invested a larger proportion of their resources in bonds than have the city banks.

In accordance with the theory of a "secondary reserve," the proportion of their resources which the banks might be expected to maintain in the form of such securities should be—apart from seasonal, cyclical, and sectional fluctuations—reasonably constant.

[1] *Report of the Comptroller of the Currency*, 1909, p. 9.

As a matter of fact, practically from the establishment of the national banking system to the present time the ratio of security holdings to banking resources has increased. Occasionally there has been decline; but thereafter the tendency has been resumed and a higher ratio attained. Nor has the gain in relative importance of securities been at the expense of any one item or group of items of banking assets. One element after another has tended to increase or diminish in response to specific episodes in our monetary history; but the point of arrest or reversal has been far less remote.

Although the banks have applied an increasing proportion of their resources to investment securities, this movement has been continuous in tendency rather than uniform or regular in pace. An examination of the changes in ratio from year to year indicates that the gain has been markedly greater in certain periods than in others. The principle of variation which might be supposed to prevail, in accordance with the theory of "secondary reserve," is that the banks buy bonds rapidly in dull times when cash accumulates and business demands slacken, and slowly or not at all (or indeed liquidate some part of such holdings as they have) when business is active and cash in demand. The actual course of variation, as exhibited in the experience of the national banks, both in the aggregate and in groups, has been notably different from this simple or absolute movement and can be summarized in the following tentative statement: The national banks buy bonds freely in periods of high business activity characterized by attendant circumstances of large cash deposits, active markets, pool operations, security flotations, and syndicate underwritings. This upward movement is checked by the fatigue which follows speculative excess and foreshadows the advent of financial disturbance. Panic strain is neither anticipated nor relieved by the liquidation of securities. With the prostration that marks the end of spasm, securities are again freely acquired—in part the enforced taking-over of hypothecated collateral, in part the productive reinvestment of swollen reserves. This prostration is succeeded by depression, marked by smaller cash deposits and inactive financing, during which the banks add but slowly to their bond holdings. If there be premature recovery, securities are bought more actively; but

with the relapse into dulness this tendency in turn is arrested. Not until business activity is resumed on a large scale are bonds again bought with rapidity and the cycle resumed.

It thus appears that the banks have continuously devoted an increasing part of their resources to the purchase of bonds, in contrast to the movement of loans and discounts and cash reserves, until the amount so invested now practically equals their paid-in capital stock. The occasions for such purchase, as evidenced by a comparison of alternating periods of rapid and slow acquisition, have been not only the accumulation of unemployed funds and the absence of other channels of profitable employment in periods of business prostration, but also the attractiveness and pressure of new security flotations by reason of syndicate participation, anticipated rise in value, or mere corporate contacts, in times of business activity. Securities so acquired have failed notably to serve as a form of secondary reserve to meet the demands of expanding business or panic strain, being non-liquid either in seasonal or in cyclical requirement.

The question now arises as to the extent to which this bond-buying policy of the banks is likely to be affected by the new law. Distinction can here as elsewhere be drawn between absolute tendency and actual conduct—between what the banks might reasonably be expected to do and what they will actually do in practice. It is clear that the chief ostensible occasion for such purchase—the fact that bonds are the only eligible forms of investment in times of idle money—will be affected by the availability of accepted commercial paper. It is also evident that changes in reserve requirements and in exchange and clearing arrangements will leave the country banks with ampler funds for investment—a condition not counterbalanced by corresponding alterations on the part of the city banks.

Too sanguine expectations have perhaps been voiced as to the development of a free discount market. As it involves an almost radical change in the methods of conducting business, some time is likely to elapse before the prevailing system of open credits and trade discounts will be replaced by a system of domestic bills and bank acceptances. Even thereafter it is not clear that paper of

this kind will be available at the required times in sufficient volume to meet the demands of banks.

Moreover, we must face the fact familiar to every practical banker that the banks buy bonds, not only to make otherwise idle money income-yielding, but also to profit by a prospective rise and to participate in modern corporate financing. Neither practice is in conformity with the soundest banking principles. In so far as the motive of such investment is the lure of larger interest return and of speculation for the rise, the practice is indefensible. In so far as the purchase of bonds by the banks has grown up as an incident of modern corporate financing—induced by the requirements of the corporations rather than by the necessities of the banks—the occasion itself is valid but the mode of its exercise improper. An essential function of an efficient money market is the temporary holding of security issues in the interval between original emission and definite absorption by investors. But this service cannot be economically undertaken nor adequately performed by commercial banks. Aside from matters of equipment and competence, there is an inevitable coincidence in time between the demand for such fiscal service and the requirement for ampler commercial accommodation—with the result of strain and cost to the credit-using community.

Accustomed as the banks are to bond-buying and its accompanying incidents, delayed in operation and undetermined in amount as the development of a discount market is certain to be, the prevailing bond-buying practice of the banks is likely to be checked rather than stopped. It is this consideration indeed which justifies the question whether some restrictive legislation upon the freedom of the banks to make such purchases might not properly figure in future legislation as a reasonable device to aid the successful operation of the proposed changes in banking procedure.

A final consideration has to do with the effect of the new measure upon the securities which the banks now actually own rather than with their future policy with respect to such investments. The same influences which are likely to check further bond-buying may be counted upon to encourage liquidation of present holdings—the proceeds to be utilized either for distribution among stockholders

or for reinvestment in commercial paper of a kind available for rediscount by the reserve banks. This liquidation tendency will in turn be delayed by the circumstance which has heretofore defeated the use of security holdings as efficient secondary reserve and which has effected practically uninterrupted increase in their absolute and relative amount—customary purchase of securities by the banks at high price levels and reluctant sale at low price levels.

Bearing in mind the fundamental soundness of the new act, the comparative banking experience of other countries, and the tremendous adaptability of American business character, there is every reason for anticipating the most salutary effects from its operation. Certainly the measure carries no menace to the owners of national banks and indeed promises correction of certain unwholesome tendencies in bank investments.

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